Editor's note: Appealed -- Civ.No. H-90-1564 (S.D. Tex. May 11, 1990), transferred to D.Wyo., Civ.No. 91-CV-0096 (D.Wyo. Apr. 15, 1991), aff'd June 19, 1992, final judgment entered Aug. 17, 1992, appeal filed No. 92-8070 (10th Cir.), dismissed Feb. 1, 1993

CIG EXPLORATION, INC.

IBLA 88-468 Decided February 14, 1990

Appeal from a decision of the Director, Minerals Management Service, requiring payment of additional royalties on natural gas produced from Federal leases. MMS-0457-O&G, MMS-0487-O&G.

Affirmed.

1. Oil and Gas Leases: Royalties: Generally

When the purchaser of natural gas produced from Federal leases reimburses the lessee for severance taxes and ad valorem taxes pursuant to a contract for purchase and sale of the natural gas, the gross proceeds received from the leases by the lessee should include the tax reimbursements. Accordingly, it is proper for MMS to demand additional royalties when the royalty payments were based on a gross proceeds determination that excluded the severance tax reimbursements.

APPEARANCES: Hugh V. Schaefer, Esq., and Stephen M. Brainerd, Esq., Denver, Colorado, for appellant; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., and Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE MULLEN

CIG Exploration, Inc. (CIGE), has appealed from a March 11, 1988, decision of the Director, Minerals Management Service (MMS), affirming two orders of the Royalty Compliance Division, Royalty Management Program (Compliance Division), MMS, dated October 15, 1987 (MMS-0457-O&G), and October 28, 1987 (MMS-0487-O&G), demanding $283,645.12 and $359,236.11, respectively, as additional royalties for gas produced from 27 Federal oil and gas leases in Wyoming between January 1980 and September 1986. 1/

1/ The leases are identified by the following lease numbers:

48-307188	48-313117	48-315879	48-317028
48-324008	48-324997	49-005427	49-005433
49-005434	49-005446	49-005447	49-007174
49-009478	49-011983	49-013325	49-019850
49-024849	49-026841	49-035882	49-036323
49-042928	49-044256	49-047197	49-049585
49-050075	49-050079	49-056323	

The Director found additional payments due because the purchaser of the gas had reimbursed CIGE for State severance and conservation taxes (MMS-0457-O&G) and State ad valorem taxes (MMS-0487-O&G) paid by CIGE and CIGE had failed to include the reimbursements as a part of the value of production when calculating royalties.

Wyoming imposes severance, conservation, and ad valorem taxes on gas production from wells within the State. By agreement, the purchaser of the CIGE gas paid a price allowed under the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. §§ 3301-3432 (1982), and reimbursed the amount CIGE paid for the above-listed State taxes. 2/ The Compliance Division concluded that CIGE should have included the tax reimbursements as a part of its gross proceeds from the leases when calculating royalties.

CIGE appealed the Compliance Division determinations to the Director, MMS, arguing that State severance taxes were post-production in nature and did not affect the value of production for royalty purposes. CIGE cited the NGPA and Federal Energy Regulatory Commission (FERC) orders in support of its position. It also contended that the Department of the Interior had no independent authority to include tax reimbursements as a part of the value of production, and that the "gross proceeds" clause of 30 CFR 206.103 (1987) did not include tax reimbursements. CIGE further asserted that MMS had misapplied the gross proceeds royalty valuation in its case.

In his March 11, 1988, decision, the MMS Director affirmed the Compliance Division determinations. Recognizing that Wyoming and certain other states consider the Federal royalty amount to be exempt from its severance taxes, the Director found this fact insufficient to negate MMS' longstanding policy of including all payments made by a purchaser to the lessee (or paid to another on behalf of the lessee) as a part of the gross proceeds accruing to the lessee. He noted that this position had been upheld by the Board and the Federal Court of Appeals for the Tenth Circuit. Accordingly, he held that, because 30 CFR 206.103 (1987) mandates that, for royalty purposes, the value of production is to be no less than the gross proceeds accruing to the lessee from the sale of the gas, CIGE must include the reimbursement of State severance and ad valorem tax payments as a part of the value of the production when computing royalties.

In its statement of reasons (SOR), 3/ CIGE repeats the arguments made before the Director and contends that, if such reimbursements were included as a part of the value of production, the Federal Government would effec- tively receive a royalty in excess of the 12-1/2-percent rate set forth by statute and applicable lease provisions. CIGE further asserts that MMS'
decision is inconsistent with the uniform ceiling price and reimbursement

2/ The record does not include a copy of the gas purchase agreement or indicate either the NGPA ceiling price or the price actually paid. On appeal CIGE asserts that it did not receive the ceiling price. However, whether CIGE received the maximum price permitted by the NGPA or some lesser amount has no bearing on the outcome of this case.

3/ CIGE titled this document "Supplemental Statement of Reasons."

scheme established under the NGPA. According to CIGE, the NGPA allows a producer to receive more than the ceiling price for the gas if the excess consists of reimbursement for State severance taxes paid by the producer. CIGE alleges that, if MMS had taken the royalty in kind, the maximum it could obtain would be the NGPA ceiling price, without the additional tax reimbursement, because it is exempt from paying the taxes. CIGE argues that the value of the gas does not, therefore, include the tax reimbursements.

Although CIGE accepts that, in Hoover & Bracken Energies, Inc. v. U.S. Department of the Interior, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984), the Tenth Circuit Court of Appeals held that severance tax reimbursements may be included when calculating gross proceeds for Federal royalty purposes, it argues that the Hoover & Bracken case is distinguishable from the instant case. CIGE contends that Hoover & Bracken is applicable only when the lessee receives the ceiling NGPA price, and the actual sales price in this case was nowhere near the NGPA ceiling price. CIGE notes that Hoover & Bracken involved a Federal communitization agreement and an Oklahoma drilling and spacing order which resulted in the pooling of royalties, which are factors not present in this case. CIGE also asserts that the court did not consider all the arguments it raises, and did not deal specifically with ad valorem taxes, as opposed to "pure" severance taxes, and therefore that case does not control here.

CIGE finally argues that the assessment of royalties on State conservation and severance taxes allows the state to increase its revenues under the Mineral Leasing Act. It bases this allegation on the fact that 50 percent of the royalties received by MMS are paid to the state. Therefore, a state could indirectly increase its share of royalty revenue by imposing a sever-ance tax or increasing the rate of an existing tax. CIGE contends that MMS' interpretation of the royalty value regulations is capricious.

In its answer, MMS contends that the basic issue on appeal is whether tax reimbursements are a part of gross proceeds upon which royalty payments are calculated. MMS argues that the Secretary has exercised his authority to establish reasonable value for royalty purposes and has determined that the lessee's gross proceeds constitute the minimum value. MMS notes that 30 CFR 206.103 (1987), which sets out the value basis for computing roy- alties, states that value for royalty purposes may never be less than the gross proceeds accruing to the lessee from the sale of the production. MMS also cites the provisions of the Notice to Lessees and Operators of Federal Onshore Oil and Gas Leases-1 (NTL-1), issued on January 25, 1977, and the Notice to Lessees-5 (NTL-5), issued on May 4, 1977, which define "gross proceeds" as including tax reimbursements, asserting that both notices are duly promulgated regulations within the meaning of the Administrative Procedure Act, 5 U.S.C. § 551(4) (1982), and reflect a longstanding posi- tion of the Department.

MMS contends that reimbursements for severance-type taxes are part of the total consideration received by the lessee and thus are part of the gross proceeds from the sale of production. It argues that the Board and the courts have conclusively held that reimbursed severance taxes must be

included in royalty valuations because gross proceeds encompass such reim- bursements, noting the central issue in the Board and the court cases is identical to the issue here. Although CIGE asserts that the severance taxes are not a part of production and therefore not subject to royalties, MMS counters that the Board and the courts have ruled that severance tax reim-bursements are part of gross proceeds, and that the regulations mandate that the value of production shall never be less than the gross proceeds. MMS concludes that severance, conservation, and ad valorem taxes reimbursed to CIGE were a part of gross proceeds during the entire period in question.

[1] The Mineral Lands Leasing Act of 1920, as amended, 30 U.S.C. § 226(b) and (c) (1982), provides that Federal oil and gas lessees shall pay a royalty of at least "12-1/2 per centum in amount or value of production reserved or sold from the lease." If royalty is not taken in kind, the royalty is 12-1/2 percent of the value of production from the lease. The Act was intended "to promote wise development of natural resources and to obtain for the public reasonable financial returns on assets belonging to the public." Mountain States Legal Foundation v. Andrus, 499 F. Supp. 383, 392 (D. Wyo. 1980). The Act reserves to the Department the authority and responsibility to establish reasonable value for royalty purposes. Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1381 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 107 S. Ct. 1593 (1987); accord, California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961); Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950); United States v. Ohio Oil Co., 163 F.2d 633 (10th Cir. 1947), cert. denied, 333 U.S. 833 (1948).

Departmental rules for determining the value of production for royalty purposes in effect during the relevant time period are found at 30 CFR 206.103 (1987) (formerly 30 CFR 221.47), 4/ which states:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director [of MMS] due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or

4/ The gas royalty valuation regulations were revised, effective Mar. 1, 1988. 53 FR 1230-84 (Jan. 15, 1988). The current applicable regulation, 30 CFR 206.151, defines gross proceeds to include severance tax reimbursements. The revised regulations also terminated NTL-1 and NTL-5. See 30 CFR 206.150(e).

> other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value. [Emphasis added.]

The Board has previously upheld the principle that when a purchaser of gas produced from Federal wells reimburses a Federal lessee/producer/seller for its severance and ad valorem tax payments, those reimbursements are properly included as part of the value of production when computing the royalty due the Federal Government. Enron Corp., 106 IBLA 394, 396 (1989); Tricentrol United States, Inc., 105 IBLA 392, 394-95 (1988); Amoco Produc- tion Co., 29 IBLA 234, 235 (1977); Wheless Drilling Co., 13 IBLA 21, 80 I.D. 599 (1973). See Hoover & Bracken Energies, Inc., 52 IBLA 27, 88 I.D. 7 (1981), aff'd, Hoover & Bracken Energies, Inc. v. U.S. Department of the Interior, supra. 5/ We set out the reasons for this rule in Wheless,
which presented circumstances analogous to those presented here: 6/

> It seems obvious to us that the buyer thus is paying to the seller an amount greater than the established field price for the natural gas it purchases from the * * * well. It follows, there- fore, that it is reasonable to compute the federal royalty of the natural gas taken from this well on a unit value consisting of the field price established by [the Federal Power Commission] plus the amount of severance tax reimbursed by the buyer. Within the con- text of 30 CFR 221.47, "gross proceeds" means the established field price for the natural gas plus any additional sums paid by the pur-chaser of the gas * * * as consideration for the purchase of gas * * *.

13 IBLA at 30, 80 I.D. at 603. We further specifically held in Wheless that "gross proceeds" consisted of "the gas purchase price plus the reimbursed severance tax." 13 IBLA at 32, 80 I.D. at 604.

The rule that gross proceeds includes tax reimbursements has been widely disseminated since Wheless. It was expressly set out 13 years ago in NTL-1, 42 FR 4546, 4548 (Jan. 25, 1977), which states in pertinent part:

> Under no circumstances will the royalty value be computed on less than the gross proceeds accruing to the operator from the sale of

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5/ In Hoover & Bracken Energies, Inc., supra, we considered a slightly dif-ferent set of facts. In Wyoming the severance tax is paid by the seller. Under Oklahoma law, State severance taxes must be paid by the buyer, and the buyer deducts the taxes from its payment to the seller.
In Hoover & Bracken, the buyer agreed to pay the NGPA ceiling price and to pay the severance tax. We ruled that, even though the obligation to pay the tax rested with the buyer, its willingness to pay the severance tax in addi-tion to the maximum NGPA price established a "value" for the gas equal to the NGPA price plus the severance tax. 52 IBLA at 37, 88 I.D. at 12.
6/ Although Wheless dealt with leases subject to a communitization agreement, the Board applied Wheless to non-unitized leases in Amoco Production Co., supra.

> such leasehold production. Gross proceeds include, but are not limited to, tax reimbursements * * *. [Emphasis added.]

NTL-5 also incorporates the same rule. 42 FR 22610, 22611 (May 4, 1977). In 1988, Congress enacted the Notice to Lessees Numbered 5 Gas Royalty Act of 1987, P.L. 100-234, 101 Stat. 1719 (1988), which modified one part of NTL-5, but left intact, and thus effectively ratified, the requirement that tax reimbursements be included in calculating gross proceeds. 7/ The Act also specifically stated that NTL-5 was a duly promulgated rule of the Department of the Interior.

Nevertheless, CIGE has set out several reasons for its challenge to the MMS determination that it must include the tax reimbursements as a part of gross proceeds for royalty purposes. We find none of these challenges to be persuasive.

Although CIGE argues that severance and ad valorem taxes are not part of production, and therefore do not affect the value of production for royalty purposes, the reimbursement of such taxes clearly is a part of the gross proceeds accruing to the lessee from the sale of the gas. The value of a unit of gas is what a buyer is willing to pay for it. Walter Oil and Gas Corp., 111 IBLA 260, 264 (1989); Enron Corp., supra at 397. CIGE's custo-mer is willing to pay both the NGPA price and the severance taxes. Thus the amount the purchaser actually pays for the gas is the sum of the "purchase price" and the "reimbursement" amount. CIGE's argument that, by including tax reimbursements as a part of gross proceeds, the Government is able to collect royalties in excess of 12-1/2 percent, has previously been rejected by this Board. Amoco Production Co., supra at 236; Wheless, supra at 604; see Kerr-McGee Oil Industries, Inc., 70 I.D. 464 (1963).

CIGE contends that including tax reimbursements in the value of production violates the provisions of the NGPA. This contention has been dis-missed by the Board and the courts. See Hoover & Bracken Energies Inc. v. U.S. Department of the Interior, supra at 1493; Enron Corp., supra at 39899. As the court stated in Hoover & Bracken: "The recent enactment of the NGPA does not affect the soundness of the reasoning present in Wheless." 723 F.2d at 1493. Similarly, none of the factors raised by CIGE in its attempt to distinguish Hoover & Bracken negate the court's affirmance of the Board's decision in Wheless. Clearly, the principle set out in Wheless controls in this case.

7/ This legislation changed one requirement of NTL-5 with respect to pro- duction from 1982 to 1986 from certain wells. Under NTL-5, the base value for royalty purposes was either the actual price received or the ceiling price, whichever was higher. After 1982, actual gas prices in many areas declined below the ceiling price, but lessees were still required to pay royalty based on the higher ceiling price. The new statute provided that the value of production for certain leases between 1982 and 1986 would be based on the actual price received instead of the ceiling price. This provision does not apply to this appeal.

CIGE assumes that the value of the gas to the United States is what the United States could sell the gas for if it had taken its royalty in kind. It asserts that, because MMS would not be taxed, it would not be able to obtain the severance and ad valorem tax reimbursements, and therefore the gross proceeds from production should not include those reimbursements. This argument also fails. As we stated in Hoover & Bracken:

> If, however, the Government were to take its royalty interest in kind, the implicit assumption would be that it had a use for the gas. The value of this gas is, therefore, properly computed as the price which the United States would pay on the open market if it were purchasing the gas as an ordinary purchaser. The fact that the United States cannot be assessed state severance tax does not depreciate the value of the gas to it. Immunity from state taxation is a function of the Federal Government's sovereignty, which prevents the state from assessing a severance tax. This benefit flows to the Government, not the lessor.

52 IBLA at 37, 88 I.D. at 12.

As noted, the applicable regulation directs that there are no circum-stances in which the value of production may be less than the gross pro-ceeds accruing to the lessee, and both NTL-1 and NTL-5 (which was recognized by Congress as being a duly promulgated rule of the Department) define gross proceeds as including tax reimbursements. The Department, including this Board, is bound by this regulation and the notices. See Walter Oil & Gas Corp., supra at 266; Coastal States Energy Co., 110 IBLA 179, 183 (1989). Therefore, MMS properly determined that CIGE must pay additional royalties because its royalty payments were made using a value which excluded the tax reimbursements.

To the extent not specifically addressed herein, CIGE's arguments on appeal have been considered and rejected.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed.

R. W. Mullen
Administrative Judge

I concur:

John H. Kelly
Administrative Judge